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SIPDIS

TREASURY FOR PLANTIER

SENSITIVE BUT UNCLASSIFIED

E.O. 12958: N/A
TAGS: EFIN TU
SUBJECT: IS TURKEY'S FISCAL POLICY TOO TIGHT?

¶1. (SBU) Summary: The very large size of Turkey's primary fiscal surplus target -- 6.5 % of GDP for the last four years -- has emerged as a key issue in discussions between the IMF and Turkey. While the IMF seems to have prevailed in its insistence on additional fiscal tightening in 2006, there appear to be strong economic and political arguments for greater flexibility. Given the importance of sustaining and deepening the economic reform effort in Turkey, Post recommends that Washington agencies take a close look at this issue and discuss its implications with the IMF. End Summary.

IMF Tightening an Already-tight Fiscal Policy

¶2. (SBU) Though frustrated in recent years over the IMF's insistence on fiscal austerity, the GOT has bowed to the Fund's requirement that it maintain a 6.5% of GDP primary surplus (non-interest expenditures less revenues) budget target. 2005 will be the fourth year the GOT has met or come close to this target, which we understand represents the tightest budget constraint of any IMF program, with the possible exception of Jamaica.

¶3. (SBU) In recent weeks, the GOT quietly pressed the IMF to reduce the target slightly for the 2006 budget, to around 6.25% of GDP. The Turks argued that this would take into account the expected privatization of state companies (Turk Telekom, Tupras and Erdemir) that currently contribute about 0.25% of GDP in net revenue. The IMF staff, however, has insisted on the 6.5% target, so as to restrain domestic demand and thereby moderate import growth that is exacerbating Turkey's worrisome current account deficit. In fact, maintaining the target despite the loss of state company net revenue would represent an additional tightening of fiscal policy in 2006.

The Economic Counterargument

¶4. (SBU) The IMF's belief that additional fiscal restraint would help trim the current account deficit is not shared by all local observers, many of whom believe that the growth in the deficit is driven by strong inflows of short-term funds attracted by high domestic interest rates rather than by import growth. There is a particular risk of a surge in inflows following the start of EU accession negotiations. These observers allege the IMF is being doctrinaire in sticking with the high primary surplus target and not recognizing the progress Turkey has made in reducing its vulnerability to shocks.

The Political Counterargument

¶5. (SBU) At the same time, the political cost of implementing a very high level of budget austerity keeps growing the longer the effort is maintained. This has created pressures for populist responses that are increasingly difficult for the AK Government to resist, especially as it continues to pursue unpopular political reforms linked to EU accession (including vis a vis Cyprus). One senior bank economist told us that even a symbolic relaxation of the budget target (like that suggested by the GOT) could create the political space the GOT needs to sustain economic reforms over a longer period. Factually true or not, many Turks believe that that the benefits of Turkey's post-crisis economic success have not been felt by the man on the street. Given the GOT's need to show results ordinary Turks will appreciate, some flexibility on fiscal austerity -- or at least no tightening -- might enable the GOT to sustain controversial reforms, including extremely unpopular structural reforms and privatizations.

Comment

¶6. (SBU) Although the GOT may be acquiescing to the Fund's demands under deadline pressure (the Constitution requires that budget parameters be set by October 17), the economic argument for increased tightening is not entirely clear. At the same time a calculation that did not let the GOT off the fiscal hook but allowed the Government to show that good efforts are rewarded has a strong political logic. Post recommends that Washington may want to explore these issues in greater detail with the IMF and IMF board.
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